In the Supreme Court of the United States

OCTOBER TERM, 1970

No. 743

ERNEST L. STEWART, TRUSTEE IN BANKRUPTCY,
PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINIONS BELOW

The referee's memorandum opinion and order (Pet. App. C 12a–18a) and the district court's order affirming the referee (Pet. App. B 11a) are not officially reported. The opinion of the court of appeals (Pet. App. A 1a–11a) is reported at 423 F. 2d 319.

JURISDICTION

The judgment of the court of appeals was entered on June 24, 1970, and the petition for a writ of certiorari was filed on September 22, 1970. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

409-874—70

QUESTION PRESENTED

Whether the government is entitled to priority of payment (under Sections 17a(1)(a) and 64a(4) of the Bankruptcy Act) of its claim for income tax deficiencies for tax years more than three years prior to bankruptcy that were not assessed until after bankruptcy because of an agreement extending the applicable limitations period.

STATUTES INVOLVED

The pertinent provisions of Section 17a(1) and 64a(4) of the Bankruptcy Act, as amended, and Sections 6211(a) and 6213(a) of the Internal Revenue Code of 1954 are set forth in the Appendix, *infra*, pp. 11–13.

STATEMENT

A timely Internal Revenue Service examination of income tax returns filed by Indian Lake Estates, Inc., for its corporate fiscal years ending July 31, 1957, 1958 and 1959, disclosed possible inaccuracies in the deductions claimed and the treatment of certain income items. These matters involved substantial legal and factual issues and were complicated by related litigation involving Indian Lake.[1] To prevent interruption of the ensuing audit and conference procedures, Indian Lake and the Service from time to time

[1] *Indian Lake Estates, Inc.* v. *Lichtman*, 311 F. 2d 776 (C.A.D.C.); *Indian Lake Estates, Inc.* v. *Ten Individual Defendants*, 350 F. 2d 435 (C.A.D.C.); *Indian Lake Estates, Inc.* v. *Special Investments, Inc.*, 154 So. 2d 883 (Fla. App.)

executed waiver agreements which had the combined effect of extending the assessment period for the tax years in question to June 30, 1966. (Pet. 2a.)

After an unsuccessful attempt to reorganize under Chapter X of the Bankruptcy Act, Indian Lake was adjudicated a bankrupt on April 16, 1965. At that time the Service had neither assessed the additional taxes claimed nor mailed a formal notice of deficiency for any of the years in issue. On November 29, 1965, the government filed in the bankruptcy proceedings a proof of claim for asserted additional income taxes and certain employment taxes, as an unsecured priority creditor.

Prior to 1966, no federal, state and local taxes were dischargeable in bankruptcy and such taxes were entitled to priority payment under Section 64a(4) of the Bankruptcy Act. Section 17a(1) of the Bankruptcy Act (Appendix, *infra*, p. 11) was amended in 1966 to provide that, with certain enumerated exceptions, provable debts for taxes which became legally due and owing more than three years preceding bankruptcy are discharged; a companion amendment to Section 64a(4) (Appendix, *infra*, pp. 11–12) provides that only taxes not discharged are now entitled to priority of payment.[2] Proper interpretation of one of the enumerated exceptions is the issue in this case.

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[2] The 1966 amendments are expressly made applicable to this proceeding as one pending at the time of their effectiveness. See Pet. 4 n. 1.

Under Section 17a(1)(c) (Appendix, *infra*, p. 11), the general discharge provision of Section 17a(1) is inapplicable to taxes—

> which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt * * *.

The government urged that its claim against Indian Lake for additional income taxes was within the exception of Section 17a(1)(c), and thus was entitled to priority of payment. The trustee objected, arguing that the taxes claimed became due and owing more than three years prior to bankruptcy, were therefore dischargeable debts under Section 17a(1), and were thus not entitled to priority. The referee sustained the trustee's objection (Pet. App. C 12a–18a) and was in turn sustained by the district court (Pet. App. B 11a). On appeal, the Fifth Circuit held that the taxes claimed were within the Section 17a(1)(c) exception and accordingly reversed (Pet. App. A1a–11a).

ARGUMENT

The decision of the court of appeals is correct and there is no conflict of decisions or other reason for further review by this Court.[*]

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[*] The petition suggests (Pet. 8, 23–24) that the present case involves problems similar to those posed in *California State Board of Equalization* v. *Carlson*, No. 150, this Term, and *United States* v. *McGuggin, Trustee*, No. 241, this Term. Certiorari in *Carlson* and *McGuggin* was, however, denied on October 12, 1970.

1. Petitioner asserts (Pet. 8–16) that the interpretation of Section 17a(1)(c) by the court below is contrary to the "clear intent" of Congress in enacting this amendment. In general, the 1966 legislation was intended to strike a balance between achieving more effective rehabilitation of the bankrupt and more equitable distribution of the bankrupt's assets among his creditors, on the one hand, and the necessity of protecting the tax revenues, on the other. H. Rep. No. 687, 89th Cong., 1st Sess. pp. 3–4 (1966–2 Cum. Bull. 770, 772). S. Rep. No. 1158, 89th Cong., 2d Sess. pp. 3–4 (2 U.S.C. Cong. & Adm. News (1966) 2468, 2470–2471). In resolving these conflicting demands, Congress determined that claims for taxes should be dischargeable, as are other debts, but not in certain circumstances.

Critical to the present case is a determination of the scope of the exceptions to discharge of tax claims—specifically, the exception of Section 17a(1)(c). The overall congressional objective of rendering tax claims dischargeable is, as the court below found (Pet. App. A 7a), of little help in deciding the meaning of express exceptions to that overall objective. Petitioner therefore incorrectly concludes that the decision of the court below must be reversed because its interpretation of Section 17(a)(1)(c) does not comport with the overall objective; the very provision here in question, as an exception, cannot comport with that objective.

2. The exception of Section 17a(1)(c) provides first that it is applicable only to taxes "which were not reported on a return made by the bankrupt." The court below held (Pet. App. A 9a–11a) that this phrase encom-

passes all situations in which the *tax* shown on the return is less than the tax as finally determined. Challenging this conclusion, petitioner asserts (Pet. 17–20) that the phrase is applicable only to tax liabilities resulting from *transactions* not disclosed on a return. In the plain language of the phrase, taxes are "not reported on a return" when the taxpayer incorrectly understates on his return the taxes he owes. In the absence of legislative history as to the intent of this specific phrase, there is no basis for petitioner's strained reading other than his contention that the general congressional intent behind Section 17a(1) should govern. See *In re Cohen*, 1968-1 U.S.T.C. par. 9250 (N.D. Ga.); *accord*, 1 Collier on Bankruptcy (14 ed.), Sec. 17.14 [4], p 1620; *contra, In re Michaud*, 1970-2 U.S.T.C. par. 9658.*

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*In *Cohen*, the Service had issued a 90-day letter and the bankrupt had filed a redetermination petition in the Tax Court prior to bankruptcy. The bankrupt argued that because he had reported all of his income and deductions on his return, the first condition of the Section 17a(1)(c) exception was not satisfied. This assertion the court rejected, finding it immaterial since the exception refers to the tax liability reported on the return, not to items of the income and deductions. Thus while *Cohen* is distinguishable in other respects from the present case, it is directly in point as regards the first condition of Section 17a(1)(c).

In *Michaud*, again a Tax Court suit was pending at the time of bankruptcy. The additional taxes asserted by the Service resulted from disallowance of deductions claimed in the bankrupt's return; the bankrupt argued, as in *Cohen*, that the first condition of Section 17a(1)(c) was not satisfied. The district court, although attempting to distinguish *Cohen* and the present case, held that the first condition is met if the facts upon which tax liability is computed are fully disclosed, and the tax based thereon properly computed, in the bankrupt's return, even though

Petitioner objects (Pet. 13) that the interpretation by the court below will result in the first condition of Section 17a(1)(c) being met in every instance in which a tax deficiency exists. Section 6211 of the Code (Appendix, *infra*, p. 12) defines a "deficiency" as the amount by which the tax as finally determined exceeds "the amount shown as the tax by the taxpayer upon his return." Since Section 17a(1)(c) also focuses on the *taxes* not reported, as does Section 6211, the result to which petitioner objects is quite proper.

3. Section 17a(1)(c) provides additionally that it is applicable only to taxes "which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt." The court of appeals held (Pet. App. A 7a–9a) that since Section 6213(a) of the Code (Appendix, *infra*, pp. 12–13) prohibits an assessment until after mailing by the Service of a notice of deficiency (the 90-day letter), and since the 90-day letter had not been mailed at the time of bankruptcy because of the then-pending administrative proceedings, the additional taxes here were not assessed prior to bankruptcy "by reasons of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt." Petitioner concedes (Pet. 20) that administrative proceedings were pending at the time of bankruptcy, but argues (Pet. 20–22) that since the

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subsequent disallowance of claimed deductions results in a greater tax. This decision is being appealed by the government.

Service was free to mail the deficiency notice notwithstanding the administrative proceedings, its inability to make an assessment was not "by reason" of the prohibition imposed by Section 6213(a), but rather because it chose not to mail the deficiency notice. But Section 6213(a) plainly prohibits an assessment until the deficiency notice is mailed; that the Service theoretically could have mailed the notice is immaterial where, as here, it can not do so, practically speaking, during the pendency of its administrative proceedings because of the consequences that would follow. Thus, in realistic terms, an assessment could not have been made until the bankrupt exhausted its administrative remedies, which admittedly it had not done when its bankruptcy occurred.

Petitioner fails to consider that mailing of the deficiency notice effectively terminates the administrative proceedings before the Service, since the taxpayer must respond to that notice by filing suit in the Tax Court generally within 90 days after mailing or be bound by the Service's redetermination of tax.[5] To provide both the Service and the taxpayer ample time in which to settle their differences, extension agreements waiving the usual three year limitation bar are frequently executed and negotiations continued—as was done here. Under petitioner's interpretation, con-

[5] The Service's Statement of Procedural Rules, 26 C.F.R. Sec. 601.101 et seq., provides for exhaustive administrative proceedings before either party must resort to litigation. See 26 C.F.R. Sec. 601.105; Sec. 601.106. The clear purpose of these rules is to avoid litigation whenever possible. See *Luhring* v. *Glotzbach*, 304 F. 2d 560, 564–565 (C.A. 4). Such purpose is frustrated and defeated under petitioner's construction.

tinuing administrative proceedings beyond the three-year limitations period would result in the government's claim for taxes being discharged on subsequent bankruptcy. If this construction were accepted, obviously the Service no longer would continue its administrative proceedings beyond the three-year period with any taxpayer for whom bankruptcy is a possibility. On the other hand the interpretation of the court below avoids any such inconsistencies with existing Service practice, which is of substantial benefit to taxpayers.*

CONCLUSION

It is therefore respectfully submitted the the petition for a writ of certiorari should be denied.

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*The importance of existing Service administrative procedures is illustrated by the following statistics: In 1967, there were 51,123 cases pending before the Appellate Division of the Internal Revenue Service in which taxpayers filed protests against the findings of examining officers but had not filed petitions with the Tax Court. Approximately 83 per cent of these cases were disposed of by agreement. See 1967 Annual Report, Commissioner of Internal Revenue, Pub. No. 55, p. 27. Petitioner's construction, curtailing as it would Service administrative proceedings before completion, would certainly result in additional tax litigation.

APPENDIX

Bankruptcy Act, c. 541, 30 Stat. 544 (as amended by Sec. 1, Act of June 22, 1938, c. 575, 52 Stat. 840):

SEC. 17 (as amended by Sec. 2, P.L. 89-496, 80 Stat. 270) *Debts not affected by a discharge.*—

a. A discharge in bankruptcy shall release a bankrupt from all of his provable debts, whether allowable in full or in part, except such as (1) are taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof within three years preceding bankruptcy: *Provided, however,* That a discharge in bankruptcy shall not release a bankrupt from any taxes (a) which were not assessed in any case in which the bankrupt failed to make a return required by law, (b) which were assessed within one year preceding bankruptcy in any case in which the bankrupt failed to make a return required by law, (c) which were not reported on a return made by the bankrupt and which were not assessed prior to bankruptcy by reason of a prohibition on assessment pending the exhaustion of administrative or judicial remedies available to the bankrupt, (d) with respect to which the bankrupt made a false or fraudulent return, or willfully attempted in any manner to evade or defeat * * *.

(11 U.S.C. (Supp. IV) 35.)

SEC. 64 (as amended by Sec. 3, P.L. 89-496, 80 Stat. 270) *Debts which have priority.*—

a. The debts to have priority, in advance of the payment of dividends to creditors, and to be paid in full out of bankrupt estates, and the

order of payment shall be * * * (4) taxes which became legally due and owing by the bankrupt to the United States or to any State or any subdivision thereof which are not released by a discharge in bankruptcy: *Provided, however,* That no priority over general unsecured claims shall pertain to taxes not included in the foregoing priority: *And provided further,* That no order shall be made for the payment of a tax assessed against any property of the bankrupt in excess of the value of the interest of the bankrupt estate therein as determined by the court * * *.

(11 U.S.C. (Supp. IV) 104.)

Internal Revenue Code of 1954 (26 U.S.C.):

SEC. 6211. DEFINITION OF A DEFICIENCY.

(a) *In General.*—For purposes of this title in the case of income, estate, and gift taxes. imposed by subtitles A and B, the term "deficiency" means the amount by which the tax imposed by subtitles A or B exceeds the excess of—

(1) the sum of

(A) the amount shown as the tax by the taxpayer upon his return, if a return was made by the taxpayer and an amount was shown as the tax by the taxpayer thereon, plus

(B) the amounts previously assessed (or collected without assessment) as a deficiency, over—

(2) the amount of rebates, as defined in subsection (b)(2), made.

* * * * *

SEC. 6213. RESTRICTIONS APPLICABLE TO DEFICIENCIES; PETITION TO TAX COURT.

(a) *Time for Filing Petition and Restriction on Assessment.*—Within 90 days, or 150 days if the notice is addressed to a person outside

the States of the Union and the District of Columbia, after the notice of deficiency authorized in Section 6212 is mailed (not counting Saturday, Sunday, or a legal holiday in the District of Columbia as the last day), the taxpayer may file a petition with the Tax Court for a redetermination of the deficiency. Except as otherwise provided in Section 6861 no assessment of a deficiency in respect of any tax imposed by subtitle A or B and no levy or proceeding in court for its collection shall be made, begun, or prosecuted until such notice has been mailed to the taxpayer, nor until the expiration of such 90-day or 150-day period, as the case may be, nor, if a petition has been filed with the Tax Court, until the decision of the Tax Court has become final. Notwithstanding the provisions of Section 7421(a), the making of such assessment or the beginning of such proceeding or levy during the time such prohibition is in force may be enjoined by a proceeding in the proper court.

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